FINly / Finstreet's Weekly Newsletter

K. J. Somaiya Institute of Management Studies and Research

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The little things

- **Forex reserves:** $292.04 bn (as on Sep 7)
- **Brent Crude:** 114.86 USD/ bbl as (on Sep11)
- **Sensex:** 18464.27 (as on Sep 14)
- **Gold (10 gm)**: Rs.32580.50 (as on Sep 16, Mumbai)
- **Exchange rate (Rupee)**: 54.30/$ (as on Sept 16)

Did you know?

- Risk perception on equities varies from 56% - for high-income (above Rs 5 ,00,000) earners, to over 65% - for those earning Rs 90,000-2,00,000 per year.
- As of 2011, American's owed about $875 billion in student loans, which is more than our country collectively owes in credit card debt.

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Govt. clears 51% FDI in retail, 49% in aviation

The Govt. has given a go-ahead to foreign investment in multi brand retail & aviation and also for disinvestment in 4 public sector companies-Hindustan Copper, Oil India MMTC and Nalco-which is expected to raise around Rs 14000 crore. The announcement of these reforms led to a 443 point rally in the Sensex.

Diesel prices hiked by 5/ltr, cooking gas subsidy cut

The government announced the highest ever 12 % hike in diesel prices and reduced the number of subsidized cylinders to 6 per family per year. The government seeks to reduce the fiscal deficit and stave off a rating downgrade for India through these moves. This move has cheered industry leaders but it has predictably evoked strong protests from political parties.

ECB's bond-buying plan

The President of European Central Bank unveiled a proposal that would enable ECB to purchase unlimited government bonds from member countries with the objective of preserving the euro "whatever it takes". This plan targeted to enable economies - such as Italy and Spain - to access cheaper funds from the ECB, has been opposed by the chief of the German Central Bank saying that it sounds like in effect printing money to bail out wayward economies. On Sept 12, the German constitutional court dismissed a complaint arguing that this plan was against the country's constitution.

Decline in Subscribers of top 3 telcom companies

Mobile phone subscriber numbers of the country's largest GSM operators — Bharti Airtel, Vodafone and Idea Cellular — fell for the first time in over a decade in August. The 3 GSM operators have jointly lost about 5 million customers. Decline could be attributed to the fact that key markets in the country were reaching a saturation point, and many customers have not renewed their second or third mobile connections.

Infosys acquires Lodestone, biggest buy at 1,932 cr

India's second-largest software exporter said it would buy Lodestone Holding, a Switzerland-based consulting company specializing in business software from Germany's SAP, for about $350 million (1,932 crore), giving it better reach in continental Europe. The share has since then rallied 5% and closed at Rs 2632.

Point – Counterpoint

Was the GoI wrong in allocating coal blocks at nominal prices?

The essence of the entire Coalgate controversy is the CAG's argument that the government had the authority to allocate the coal blocks by the process of competitive bidding, which they intentionally chose not to use and rather allocated the mines in an arbitrary manner which, as claimed in the CAG Final Report tabled in parliament, resulted in a loss to the extent of Rs 185,591 crore (US$33.59 billion). On the other hand UPA has consistently maintained that there has been no discrepancy in the allocation process and the loss estimated is highly exaggerated and government was not wrong in allocating the mines at nominal rates. Following is the POINT- COUNTERPOINT of the issue:

Yes!

The allocation of natural resources should be done through the process of competitive auctioning/bidding, which tends to bring the price near its actual market price. This follows naturally from the laws of economics. The existence of healthy competition always works to enhance the productivity of the sector and ultimately results in low costs to the end consumer.

The process, if carried out through bidding, would have landed the government more revenues. Instead, it resulted in "windfall gains" (as noted in the CAG report) to the tune of nearly US$ 200 billion to the companies that landed themselves lucrative deals for these coal blocks.

The process of competitive bidding ensures that the parties winning the bids act more competitively and act in a manner so as to make the most of their investment.

The coal-mining industry was nationalized for a long time. Output of this industry was always deficient and there was much needed and recommended participation from capable private players, to be able to meet the ever-increasing demand. The private companies also had to be captive users of coal to be eligible for coal blocks allocations.

The allocation of these blocks for captive prices happened at a nominal price, way below the market prices, and for use for a long period of time. This is a wasteful method of utilizing a country's valuable natural resources. The Government of India had the power to auction the coal blocks in the allocation process of the year 2005, but didn't do so.

The bidding process could have been enacted through an administrative decision in that particular year, and for every year after that till 2009, but was continued to be allocated through the Inter-Ministerial Group, called the Screening Committee. The CAG report also states that there was no legal barrier to the implementation of this decision. This shows indiscretion on the part of the ruling party at the time.

No!

The fundamental objective of the auction is to let the efficient players grab the mines which in turn are expected to bring the coal prices down. However, auction will only bid up the prices and that will defeat the objective of low prices as the successfully bid companies will set high prices to break even the heavy investments made on acquiring the resources.

And the figures posted by CAG are exaggerated because of the average costing process employed to arrive at the figures. Though, assumptions are a valid way in performing estimations, it should have been sufficiently efficient enough to warrant credibility. Also, the figures were not discounted over time as considering the fact the life of an average mine is about 30 years, and with an average interest rate of 10%, the figure will shrink substantially.

The efficiency of CIL alone can't be blamed per se without looking at the inadequate infrastructure (eg: rail connectivity between the mines and the factories et al) that the Government has provided with the company. The company itself would have developed the infrastructure all by itself had it not been forced to sell coal at subsidized prices which are as much as 77% below the international price levels.

Also, 65% of electricity demand is met through thermal power and thus the end prices for electricity are ultimately decided by the coal prices. Thus, Government had to make a choice between the revenue maximization through auction process and its primary objective of keeping the prices to the end-users low.

Being private players don't necessarily make the bidders more efficient than CIL. We have seen RIL's incompetency in KG Basin case. Thus, it is not often that huge cash reserves and efficiency go together. In addition to the last point, the screening committee did ensure that the companies to whom the captive mines were allocated met the following requirements.

- Net worth of the applicant company
- Production capacity as proposed in the application
- Technical experience
- Recommendation of the state government concerned
- Track record and financial strength of the company

Land acquisition acts and reforms in India are still at a not-so mentionable state that it only makes the job of these companies to start exploration activities difficult as they can start exploring and establish logistic infrastructure only after lands are acquired. Also, a few mines which were won through bidding are immensely inaccessible for they are located deep inside the forests which not only necessitates separate treatment from the CAG while estimating the losses, it should also have taken into account the legal entanglements associated with the forest clearance activities.

The CAG computed the gains for private companies in 57 coal blocks. In this, it excluded blocks allocated to public sector companies and to joint ventures of public sector companies with private companies. Thus, it can be said that the coal mine allocation process was sufficiently effective and efficient when given much deeper and unbiased deliberation.

STAGFLATION

Stagflation, which was considered to be an unusual and impractical theory by many in the past, disproved the notions of Keynesian macroeconomic theory when it first hit the US in the late 1970s. The impact was very severe that it led to a swing in the subsequent presidential elections. In India, lately we have been reading a lot about stagflation and it has become a topic of concern among the leading financialists and for the Indian government. India, a country which was one of the first to get out of 'Great Recession' and was growing with a good GDP, is now in a position of falling into the trap called stagflation. So will India fall in the trap?

To answer this question, first we need to understand what Stagflation is really about and what circumstances led to this position in India. Stagflation is a state when the inflation rate of a country is very high and its Gross Domestic Product (GDP) is very low. It is also seen that these are accompanied with high unemployment in the country. Stagflation is caused when there is a supply shock, which is due to the sudden increase in some of the product prices that are imported by a country. Due to this, there is an increase of production costs and hence the profit margin of the industry gets reduced. To get profits, industry tries to raise prices, cut the number of unskilled labors, etc. So, the increase in price leads to inflation, reduction in profits leads to decreased economic growth and by cutting the unskilled labors unemployment increases. This leads to a situation called Stagflation. It is often said that stagflation is a trap because there is no definite way which is defined to come out of this situation.

If we consider India, oil is the major import. Oil prices have been very volatile in recent times. Due to this, oil prices in India are not stable and it has increased to an extent never seen before. Oil is the major source of energy in India. The rise in Oil prices has led to increase in the price of many products and hence inflation is also rising day by day. In addition to this, the crisis in the Euro zone and slow economic growth around the world has stalled the growth in India too. India, which was growing at a rate over 9 per cent in 2010, now faces a growth rate of just below 6 per cent. This economic slowdown in India is strongly attributed to the paralysis of Indian government in developing reforms. When the growth rate is declining steadily, the government is not well equipped with reforms to repair its economy. The Central Bank is also unable to reduce its interest rate because of the already high inflation rate in the country. It is high time for the government to introduce reforms and to bring in investments to improve the economic growth.

Though we have these many data to show slowing of economic growth and increase in inflation rate, there is another question that arises in our mind. So, is this the right time to worry much about stagflation with a decent enough growth rate? This question arises because, when the stagflation occurred in US, its GDP was negative and the inflation rates were as high as 12 percent. The unemployment rate was also way beyond the comfort level. Now India is growing around 6 per cent and the inflation rate is slightly above 8 per cent. Though the figures seem to be decent enough India has failed to achieve its targeted growth and missed fiscal deficit target consistently in the past 12 months.

With the economic slowdown and policy paralysis, the future also doesn't seem bright. In the RBI monetary policy, released in June 2012, the RBI reduced its GDP projection by 70 basis points and increased the inflation rate by 80 basis points which clearly signify that it is high time for the government to get concerned. It is also seen that the GDP of India has been in the declining phase for more than four quarters. In its report, RBI has asked the government to reduce the expenditure to reduce its fiscal deficit. These factors have made stagflation a serious threat for India.

As we have seen from the past that there is no particular solution to deal with stagflation. The central bank is unable to reduce its rate because the inflation rate is already high and hence it is the now in the hands of government to take radical steps to reduce its expenditure and try to meet their targets set by them in the 12th five year plan. This can help in reduction of taxes and prices to some extent which in turn help in improving the economy and reduce inflation.